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Backgrounder

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A Little Rhythm Could Help the Bank of Canada Stay Cool: The Case for Regularly Scheduled Bank Rate Decisions

by

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Over the past year, Canada's monetary scene has been pretty cool. Short-term interest rates are rising, but no more than seems consistent with healthy economic growth and low inflation. The Canadian dollar has strengthened, and bond yields remain below those in the United States. This calm period offers the Bank of Canada an opportunity to plan ahead for the next time things get hot. It should now add rhythm to its routine and adopt a regular schedule, like that used by the US Federal Reserve and other central banks, for decisions and announcements about possible changes to the Bank Rate — the key interest rate at which financial institutions needing short-term funds can borrow.

Since early 1996, the Bank has followed an *ad hoc* approach to setting the Bank Rate. It changes the rate whenever its Governing Council sees fit — most recently on February 3, when it raised the rate to 5.25 percent, immediately following a similar move by the Fed.

Before 1996, the Bank Rate was automatically set slightly above the yield established in weekly auctions of Government of Canada treasury bills. The Bank dropped this system because other influences on T-bill rates often muddied the signals it wished to send financial markets, and it felt that market reactions to these mixed signals complicated the conduct of monetary policy. Similar in many ways to the establishment of inflation targets at the beginning of the decade, the new system gives Canadians generally, and financial market participants particularly, a clearer view of the Bank's intentions, simplifying the task of keeping monetary conditions on track.[1] Putting de-

1 Also in the interest of transparency, the Bank had earlier established a 50 basis point target band for the one-day interest rate. The Bank Rate is at the top of the band.

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cisions about the Bank Rate on a regular rhythm could improve things still further.

Ad hoc, arrythmic changes in central bank lending rates present two related hazards. To start, they can focus policymakers' attention too much on the short term. Even though central banks with regular decision dates can change their lending rates at other times, a regular cycle tends to focus attention less on hourly and daily noise and more on longer-term information about the economy. Because a system that allows changes at any time has fewer institutional checks against reacting to transitory events, it may make such reactions more likely. The related hazard is that securities and foreign exchange traders, knowing that the central bank may act at any time, begin trading with one eye fixed on it. When they do, the feedback between central bank and financial market actions becomes more complicated, making it harder to steer monetary policy with a cool head.

Why does more complicated feedback between the Bank of Canada and financial markets matter? Over periods as long as months or quarters, money growth and key economic indicators such as consumer spending, factory orders, and job creation give the Bank advance notice about whether inflation is likely to come in on target or whether policy needs adjusting. Over shorter periods, however, these signals can be harder to read or may not even exist. From day to day, therefore, the Bank relies mainly on financial market signals — especially movements in interest rates and the exchange rate — to judge whether its actions are having their intended effect.

Interest rate and exchange rate movements often provide useful information because, among other things, they reflect changes in expectations about where Canada's economy and inflation rate are going and about how Canada is faring relative to the rest of the world. But if uncertainty about the Bank of Canada's next action becomes an important driver of interest rate and exchange rate movements, unhelpful circular feedback contaminates the signals they give. The more these movements are themselves driven by traders' changing expectations about what the Bank is going to do, the harder they are to read.

The past decade provides some examples of the problems this feedback can create. Especially during the early 1990s, the Bank steered policy by the monetary conditions index (MCI), a weighted average of the yield on three-month T-bills and the exchange rate of the Canadian dollar against the currencies of Canada's major trading partners. The MCI is intended to provide a useful summary measure of the influence of financial market conditions on economic activity, but the explicit tradeoff between interest rates and the exchange rate that it portrays has important drawbacks.[2] One drawback is that traders of fixed income securities and foreign exchange, noticing that the Bank tended to offset movements in the dollar (particularly downward ones) with offsetting interest rate increases, began to anticipate these moves.

At times, arbitragers played the T-bill market according to the behavior of the dollar, profiting as the Bank steered short-term rates up and down with every blip in the exchange rate. More serious for Canadians generally, because of its potentially destabilizing effects, was traders' tendency to anticipate the Bank by bidding up market interest rates whenever the dollar declined. The resulting bond market selloffs added to the sense of financial crisis that a falling currency often produces, reinforcing the Bank's incentive to raise interest rates even when nothing in the domestic economy justified it. Such an episode occurred when unsettled world financial markets undermined the dollar in the summer of 1998.

2 For discussion of the MCI's deeper flaws as a guide for policy — defects that exacerbated the feedback described here — see Kenneth J. Boessenkool, David E.W. Laidler, and William B.P. Robson, "Devils in the Details: Improving the Tactics of Recent Canadian Monetary Policy," *C.D. Howe Institute Commentary* 79 (April 1996).

Table 1: ***Schedules of Central Bank Meetings to Consider Interest Rate Policy***

Central Bank	Meeting Schedule
US Federal Reserve	every six weeks*
Bank of England	monthly
European Central Bank	every two weeks
Bank of Japan	every two weeks*
Reserve Bank of Australia	monthly*
Reserve Bank of New Zealand	every six weeks*

* Approximate; seasonal and other factors may move or eliminate some meetings.

The Bank, losing its cool, cited rising long-term rates as justification for a 1 percentage point hike in the Bank Rate — a hike that, if it had not been quickly undone, would likely have caused the expansion to stall in early 1999.

Perhaps impressed by the ease with which Australia came through the same episode with no rate increase — and by the dismal results in New Zealand, where the central bank reacted to its own MCI with a large and sustained interest rate hike that plunged the country into recession — the Bank of Canada seems to have taken a more relaxed view of exchange rate movements over the past year or so. The MCI no longer figures prominently in policy announcements, and the arbitrage opportunities it used to offer traders no longer exist. To take an optimistic view, this cooler approach may mean that, the next time financial markets get turbulent, the volatility-inducing feedback between the Bank's actions and those of the market will be less intense.

Traders could be forgiven, however, for remaining suspicious that the Bank of Canada's old hypersensitivity to the exchange rate will re-emerge. For one thing, it is easier to be casual about the exchange rate when the dollar is trending upward, as it has done since late 1998. More telling, however, is that, as the economy has strengthened, justifying somewhat higher short-term interest rates, the Bank has timed its last two moves immediately to follow interest rate increases south of the border.[3]

It is not surprising that Canada's Bank Rate and the US Federal Reserve's discount rate should follow similar courses when news about the economy and inflation in the two countries is similar. But the timing of the Bank's moves suggests strongly that it is worried that, if it raises interest rates when the Fed does not, the dollar will rise and that, if it leaves rates unchanged when the Fed raises them, the dollar will fall. In short, the domestic economy and inflation are not the Bank's only concerns in setting policy: the exchange rate still matters. Looking at the recent record, traders may expect the Bank to lose its focus on medium-term domestic targets the next time the dollar comes under pressure. If that is so, the optimistic view will not be born out, and the same potentially destabilizing feedback that has complicated monetary policy in the past will return.

It would be helpful, therefore, if the Bank of Canada took further steps to pre-empt that feedback by reducing traders' incentives to treat the exchange rate as a predictor of future changes to the Bank Rate. One way to do so would be to adopt, as the US Federal Reserve and other central banks have done (see the table), a fixed rhythm for meetings to consider and announce discount rate policy.

Suppose that, from now on, decisions on whether or not to change the Bank Rate were announced and explained at, say, 9:00 a.m. on the second Tuesday of each month. The next time financial market pressure began to push the dollar around, two things would be different. The Bank would face less daily and even hourly temptation to react to the torrent of market news flowing through phone lines and

3 As with the Bank's quarter-point hike on February 3, its quarter-point hike on November 17, 1999, also occurred one day after a similar move by the US Federal Reserve. The timing of the Bank's unwinding of the summer 1998 rate hike was also influenced by Fed action: its quarter-point cuts on October 16 and November 18, 1998, both occurred one day after the Fed had cut its discount rate by the same amount.

across its screens. Looking ahead to the next regular decision date, it could more easily take a longer-term, more measured view about whether the information received since the last decision date warranted a change in the Bank Rate. For their part, market participants would get caught up less in a volatile guessing game about whether — and when — the Bank was likely to react. Knowing the Bank would make an announcement at a set time in the near future and with the views expressed in the Bank's last announcement still fresh in memory, they could focus more on economic fundamentals and less on the psychology of the central bank.

Moving to fixed decision dates raises some questions and uncertainties. For one, fixed dates could allow people other than Bank of Canada staff to participate in the process. In some central banks, such as the Reserve Bank of Australia, discount rate changes are board decisions; in others, such as the Bank of England, the relevant committee includes outside experts. Such systems raise questions of accountability, but since the Bank of Canada's current goal is inflation targets jointly agreed with the federal government, the possibility that outside brains at the table might help the tactics of monetary policy is worth a look.

Moving to fixed decision dates, moreover, would not guarantee that monetary policy would be easier to conduct — there are many sources of destabilizing behavior in financial markets aside from uncertainty about central bank actions. And, like other central banks with fixed announcement dates, the Bank of Canada would still be able to move at other times if it chose, meaning that day-to-day scrutiny of the Bank's behavior would remain a factor in financial markets.

These elaborations noted, a move to fixed decision dates for the Bank Rate appears to impose no important costs, yet offer two related benefits. First, by abandoning its *ad hoc* approach, the Bank of Canada could focus more easily on the longer term; second, it could help reinforce its efforts to make its intentions more transparent to outsiders.

A regular rhythm for Bank Rate decisions could reduce the tendency for unwanted feedback between the central bank and markets to push Canadian monetary policy off course. Monetary policy's current steady course and financial markets' relative calm offer an excellent opportunity for such a step. The next time financial markets start to heat up, a little rhythm could help the Bank of Canada stay cool.

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